UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
----------x
UNITED STATES OF AMERICA

v. 18 CR 36 (JPO)

DAVID MIDDENDORF, THOMAS WHITTLE, DAVID BRITT, CYNTHIA HOLDER and JEFFREY WADA

Defendants
----------x

New York, N.Y.
May 31, 2018
3:05 p.m.

Before:

HON. J. PAUL OETKEN

District Judge

APPEARANCES

GEOFFREY S. BERMAN
United States Attorney for the
Southern District of New York
AMANDA K. KRAMER
JESSICA GREENWOOD
Assistant United States Attorneys

PETRILLO KLEIN & BOXER LLP
Attorneys for Defendant Middendorf
NELSON A. BOXER
AMY R. LESTER

BRUCH HANNA LLP
Attorneys for Defendant Middendorf
GREGORY S. BRUCH

CAHILL, GORDON & REINDEL
Attorneys for Defendant Whittle
BRADLEY BONDI
NOLA HELLER

APPEARANCES CONTINUED

ORRICK HERRINGTON & SUTCLIFFE LLP
Attorneys for Defendant Britt
ROBERT M. STERN
MELINDA L. HAAG
MATTHEW R. SHAHABIAN

THOMPSON HINE LLP
Attorneys for Defendant Holder
NORMAN A. BLOCH
EMILY J. MATHIEU

BROWN RUDNICK
Attorneys for Defendant Wada
STEPHEN COOK
SELVIE JASON

(In open court, case called)

THE COURT: Good afternoon. This is an argument that I scheduled on the motions to dismiss the indictment. The five defendants in this case have moved and filed briefs in various combinations seeking dismissal of Counts One through Five of the indictment in this case, and this is an opportunity to have argument on those motions.

I should say that I have about -- we can go until about 4:30, so we have an hour and 20 minutes or so, if you need to take that long. I should also say that I read the briefs, so I don't need you all to repeat what is in the briefs.

What I would like to do is -- if you have divided up the time differently, that's fine. I know some of the briefing was joint briefing, and that's fine, but I would like to give each of you an opportunity to have at least ten minutes to argue on behalf of your client. But again, I already read the briefs, so you don't need to repeat what is in the briefs.

What I haven't really done is read all the cases. I sort of started reading the cases, and I plan to read through the briefs again and the cases before I decide the motion, so I don't believe I will be in a position to rule on the motions today. But if you think about it as I have ten minutes and these are the points I really want the judge to hear and highlight when I'm reading the cases and rereading the briefs,

that's really how you should think about it.

So I think since the defendants are movants, I would like to started with you. Have you talked about a particular order?

MR. BOXER: We did, your Honor. We'll start with the joint brief of Middendorf, Whittle and Britt, and Mr. Shahabian is going to argue that brief for us.

THE COURT: Okay, very well.

Mr. Shahabian.

MR. SHAHABIAN: May it please the Court, I'm appearing on behalf of David Britt, arguing the joint motion filed by Mr. Middendorf, Mr. Britt and Mr. Whittle, and joined by Ms. Holder and Mr. Wada.

The government's argument fails to recognize what the PCAOB is and what it is not. What it is, as the Supreme Court explained in *Free Enterprise* is the regulator of first resorts and primary law enforcement authority for the accounting industry that wield the executive power of the United States. But what it is not is an agency of the United States or a part of the formal United States government.

And Congress made those choices when it enacted Sarbanes-Oxley in creating the PCAOB, and it made those choices and set up a remedial structure for violation of PCAOB rules. It specified when those rules would be enforced criminally and when they would be enforced civilly. And for the majority,

including the confidentiality rule at issue in this case, Congress specified that under Sarbanes-Oxley it would be enforced through the ample civil and administrative penalties in the act, including penalties up to $750,000 for an individual, and facing a lifetime bar from the public accounting industry.

THE COURT: That's a PCAOB rule?

MR. SHAHABIAN: That is in Sarbanes-Oxley.

THE COURT: When PCAOB issued rules, there are also PCAOB rules about not disclosing this kind of information, is that correct?

MR. SHAHABIAN: That's correct, it's part of the PCAOB ethics code. The confidentiality rule is Ethics Code 9.

THE COURT: So Ethics Code 9, is that something that is issued in the federal register?

MR. SHAHABIAN: Yes, it is, your Honor. And the federal register cite is in our opening briefing, and it explains that the statute under which the PCAOB issued the ethics code. As we explained in our opening brief, that statutory provision that instructs the PCAOB to enact the ethics code, Congress did not add triggering language for that statute that it would be enforced through criminal penalties as it did with other parts of Sarbanes-Oxley. And without that triggering language, the default penalties are the ample civil and administrative penalties. So a violation of PCAOB could be

enforced through that civil administration structure.

THE COURT: Let me ask you, before you get into your next point, or maybe it's your first point, to at a high level address the argument which I will also ask the government about why there isn't an inconsistency in the position with respect to Count One, which seems to rest on the idea that there's no conspiracy targeted because the SEC and PCAOB is a private entity versus your argument on the wire fraud counts which seems to emphasize the private nature of the PCAOB. And as I say, I will ask the government whether there's an alternative charging type problem here or an inconsistency, and about what the possibility of inconsistency in your argument as to these fraud statutes?

MR. SHAHABIAN: There is no inconsistency, your Honor. And the two cases that make that clear are the *Free Enterprise* case and the *Tanner* case. And so it's important to go back to statutes that are charged for the conspiracy counts and for the wire fraud counts. So the conspiracy count is a conspiracy to defraud, quote, the United States.

And as the Supreme Court explains in *Tanner*, as broad as that statute is, that has to be the restriction on a conspiracy to defraud the United States. It is what is actually part of the United States government for statutory purposes. And that's what the Supreme Court acknowledged in *Free Enterprise* when it noted that Congress had made the

decision not to make the PCAOB part of the formal United States government.

That's why Count One acknowledges this in not charging the object of the conspiracy as defrauding the PCAOB, which is not part of the United States, but instead the SEC, which is an entity of the United States. So it's that statutory hook that in *Tanner* the Supreme Court says must be present. It is not sufficient to charge a scheme to defraud an intermediary that may have secondary effects on the formal United States, the fraud must reach the United States.

But the wire fraud counts are a totally different question and that's why there is no inconsistency. So the wire fraud statute, as the Supreme Court explained in *McNally* is not limited to the United States government, it's not limited to any government. It was designed to protect private people and their property interests.

So what the Supreme Court started to do to in *McNally*, and most notably emphasized in *Cleveland*, is said that when the wire fraud statute is used to charge a scheme to deprive a regulatory interest under the wire fraud statute, that does not interfere with what we think of as common law property interests and is not an appropriate subject of a wire fraud prosecution.

So there's no inconsistency because the question is different. For the 371 count, the question is what is part of

the United States, and does the indictment allege a conspiracy that actually targeted at reaching and defrauding the United States government.

For the wire fraud question, the question is if the indictment charges the interference with an intangible right, is that intangible right a common law private property interest or is it a regulatory interest that is not typically referred to as property.

And so that's why even though the PCAOB is not part of the formal United States and cannot be the subject of a conspiracy to defraud the United States, because Congress made that decision in defining the United States. It still a regulator. It still exercises the executive power of the United States. It acts as regulator.

So in determining whether an interference with the intangible rights of the PCAOB is a property interest or a regulatory interest, that is what *Cleveland* demands this Court look at to see whether the PCAOB's interest in protecting the integrity of its regulatory scheme is a common law property interest protected by the statute.

THE COURT: I think that's a very strong argument. I think that the argument is that -- first of all, the PCAOB, the board itself consists of inferior officers of the United States, according to *Free Enterprise*, and those are board members who are exercising governmental power, delegated

governmental power.

But the strength of that argument, it seems to me, perhaps makes weaker your argument on Section 371 in the sense that the more -- what's happening here is regulatory activity, the more it seems a main part of what they were doing was something that was obviously going to the SEC, they were playing with information that was regulatory information that was essential to the oversight role of a government entity. And so that extent, it brings the PCAOB closer to the SEC, I would think.

MR. SHAHABIAN: So I have a few responses to that point, your Honor, and again I go back to emphasize the key cases. We think it's *Tanner* as well as *Free Enterprise*.

So your Honor noted that the Congress delegated a significant federal function to the PCAOB, even though it has decided not to make it a formal entity of the United States. The government raised that same argument in *Tanner*. It said what we have here is a private entity that is not part of the United States, but it's been delegated a significant federal function, it uses federal funds, it's supervised by a federal agency. And the Supreme Court squarely rejected that argument and said it was not sufficient to charge a conspiracy to defraud an entity supervised by the United States government or even an entity delegated a distinctly federal function, as is the case with the PCAOB.

The restriction on 371, because it's such a broad statute, as the Supreme Court noted and the Second Circuit noted, it has to be the formal United States as the target. And we don't see the indictment as really taking issue with that point, because it attempts to transform an agreement targeted at the PCAOB into a fraud on the SEC.

And this leads me to your second point, your Honor, that isn't it obvious that this is something that would reach the SEC. That is not at all obvious in what is in the indictment. The only thing the indictment charges as the agreement that the defendants agreed to to commit the conspiracy is paragraph 91 where it says there was an agreement to misappropriate confidential information from the PCAOB and use it to effect PCAOB inspection outcomes which were transmitted to the SEC and used for its undefined regulatory and enforcement functions. That never specifies what function of the SEC the defendants agreed to impede.

Your Honor mentioned the SEC oversees the PCAOB. But again, this takes us back to *Tanner*. *Tanner* rejected the arguments that federal oversight after an intermediary can constitute a conspiracy to defraud the United States. It is simply insufficient unless there is a fraud that is targeted and an actual function of the SEC.

So then get back to what is the indictment charge. And we don't know. It doesn't specify. It lists a bunch of

various functions of the SEC, including the oversight function, but it never explains what the defendants agreed to impede.

And to come back to *Free Enterprise*, the PCAOB serves an entirely separate role than the SEC. It's not simply collecting this information, bundling it up and transmitting it to it the SEC who then actually uses it to do things. *Free Enterprise* explains the PCAOB is the primary regulator. It is the front line entity that entities like KPMG are dealing with. That's why the majority of the indictment is directed at the relation to PCAOB and the defendants in KPMG. It never explained what the SEC is doing with that at the secondary level.

And to be clear, the statute mandates not only that the PCAOB transmits to the reports to SEC, but it should be transmitted to every state regulatory entity and to the public at large. So by failing to specify what it is that the SEC does with these reports, that the defendants agreed and targeted to impede, as *Tanner* requires, the Second Circuit's decision in *Pirro* makes clear that by not failing to allege the essential elements of the crime that pushed the indictment's allegations, even if true, into criminal conduct, the remedy has to be dismissal of the indictment.

THE COURT: What do you say to the argument that your argument is to some extent there's no conspiracy targeted at the SEC, there has to be a purpose and not just knowledge,

because I think the indictment does allege that there was knowledge that the information would go to the SEC, but you say that's not enough.

The government responds the cases don't require that it be the sole purpose, it can be a purpose, it can be one of several of purposes, or one of several of purposes is to defraud the SEC. Do you think that that is not adequately alleged, that it's one of several purposes to give false information that will flow to the SEC?

MR. SHAHABIAN: No, your Honor. We don't take issue to the basic premise that a conspiracy could have multiple purposes. But be that as it may, it must still charge it was a purpose to defraud the SEC.

So the cases we cite in the brief, including *Goldberg* and *Atkinson* -- *Goldberg* is a First Circuit case and *Atkinson* is from the 11th Circuit -- make clear when you have a multiple conspiracy indictment that charges a conspiracy to defraud the United States, it must be clear that one of the purposes was to defraud the United States and not that there was a secondary effect.

So to give your Honor an example of knowledge, the one that the Goldberg case explains is if several defendants agreed to rob a bank and steal money, they know they're not going to report the proceeds of that theft to IRS, but it would be ridiculous to contend that the knowledge that they're not going

to report it to the IRS is also a conspiracy to defraud the IRS in the collection of tax revenues. It must have been actually a purpose of the conspiratorial agreement to accomplish that function.

And the Second Circuit's decision in *Rosenblatt* makes this even clearer, that if the government's contention is all they need to do is track the statutory language of the defraud charge in order to charge a 371 count. The Second Circuit rejected that over 40 years ago in *Rosenblatt*. They squarely said it is not sufficient to merely say there is a conspiracy to defraud the United States, it must be clear what the essential nature of the fraud was.

THE COURT: This seems a long way from the idea of the bank robbers. Obviously the bank robbers know they're the going to defraud the IRS, but that's not their purpose. They're not thinking about the IRS when they rob the bank, they're thinking about the money.

But here, as alleged, the taking and use of the information about where the next audits will be is directly tied to the function that is the regulatory function of the PCAOB and the SEC, which are interlinked, I would think.

MR. SHAHABIAN: And that's where I disagree. That interlinking, that the function of the SEC, is not specified in the indictment as part of the agreement of the defendants. That's why I come back to paragraph 91, which is the critical

paragraph, because it's the only paragraph that actually charges what the agreement was. It just says that they knew the inspection reports would be transmitted to the SEC and used for its undefined regulatory and enforcement functions.

Now we come back to *Tanner*. *Tanner* says it is not sufficient to know that a federal agency is overseeing an intermediary like the PCAOB, it must be actually targeted at defrauding the specific function of that agency. And because of other paragraphs in the indictment, such as paragraph ten, state the SEC oversees the PCAOB, it oversees the PCAOB's inspections process, because paragraph 91 doesn't specify what function was the agreed-to target, the grand jury may have relied on those oversight allegation in deciding to indict the defendant. If that is the case, they charged a conspiracy that *Tanner* says does not constitute conspiracy to defraud the United States. That's why *Pirro* says when the indictment is not specific enough to ensure that the actual elements of the offense are charges, the indictment must be dismissed.

In addition to the targeted point, I also point out it's not just there is no agreed-to purpose to defraud the SEC, the indictment never explains what the fraud on the SEC was. Fraud is a term of art at law. It requires the submission of false statements or a violation of a duty to the United States government.

Again, coming back to *Tanner*, the Supreme Court in

Tanner didn't reverse the convictions outright. It remanded to the 11th Circuit to allow reconsideration on one consideration in the indictment, that is the indictment stated the defendants conspired to submit false statements through the intermediary to the federal agency that they had complied with the federal bidding requirements. And that was the only way the Supreme Court held in that case there could be a conspiracy to defraud the United States.

This indictment never explains what false statement was submitted to the SEC, what duty to the SEC was violated. And to be clear, because there may have been some confusion in the briefs, we're not arguing it has to be a duty that the defendants owed directly to the PCAOB. The law is clear that the defendants can use an intermediary to breach the duty the intermediary owes to the SEC, but it doesn't allege that.

THE COURT: I haven't read the relevant cases on this I don't think yet, but the government says it's not limited, as you suggest, to false statements and breaches of duty. The cases don't actually limit it to that.

MR. SHAHABIAN: That is their position, your Honor, and there is no support for that in the case law. This would be the first case to ever allow a conspiracy to defraud the United States to go forward where there's no allegation of a false statement submitted to the United States and there's no allegation of a breach of a duty to the United States.

And given the serious constitutional vagueness issues with this statute, the Second Circuit already noted, we think it would be beyond the pale to allow an indictment to go forward on an undefined novel theory of fraud like that. And the cases that the government cites for this point, *Ballistrea* and *Nersesian*, don't say there's no need requirement.

So for example, in *Nersesian*, it was a structuring case. There's a duty for a bank, if there's a transaction more than $10,000 in a single day, you have to tell the IRS. So the defendants structured their transaction to avoid the bank knowing they deposited more than $10,000 in a single day. So what the Second Circuit said is well, the bank had a duty to the United States government. You concealed the fact that would have triggered the duty and requirement to report, the bank violated a duty to the United States, that is a fraud on the United States. There's nothing like that here that shows what duty to the PCAOB owed to the SEC that was breached.

THE COURT: Doesn't the PCAOB have a statutory duty to report truthful information to the SEC?

MR. SHAHABIAN: There is no duty to report a particular kind of information to the SEC, the only duty is to transmit the reports.

So the other case that is helpful on this point is the *Murphy* case from the Ninth Circuit. In that case, undercover agents told the defendants here's some money laundering

proceeds we would like you to deposit in a bank. They set up a shell corporation, deposited on the bank, and on the transaction form listed it came from this shell corporation this is the amount of the deposit. And the government charged them with conspiring to conspire the United States by not disclosing it was money launder proceeds. But the Ninth Circuit held this statute doesn't require you to say exactly where the money came from, it's not the proceeds of money laundering, all that is required is to state who deposited and the amount, they did that, there's no breach of duty.

The only duty here for the PCAOB is to transmit the inspection reports, whatever they are, whatever they say. And there can't be false statements in them. There's no allegation of false statements here. But when it comes to a duty to disclose information, there has to be a specific duty in order for a fraud to attach based on the failure to disclose that information.

So that is why a fraud case requires either a false statement, to affirmatively submit a lie to the United States government, or a duty; you are required to do something to the United States government, you did not do it. And in the absence of failing to state what bucket of conduct we're in, this indictment on its face can't be said to charge a conspiracy to defraud the United States.

THE COURT: Do you want to turn to the wire fraud?

MR. SHAHABIAN: Yes, your Honor. This is squarely governed by the Supreme Court's decision in *Cleveland*, which explains why intangible rights that implicate regulatory interests are not covered by the wire fraud statute. This is something the Supreme Court has had to reiterate in cases like *McNally*, *Skilling*, *Cleveland*. The fraud statutes, the generic wire fraud and mail fraud statutes, cannot be used to charge intangible, vague theories of honest services fraud. They have to be tied to what is considered a common law property interest. And a regulator's ability to hold information confidential in support of a regulatory mission is not a common law intangible property interest.

And the case that we think makes that point clear is the *Hedaithy* case from the Third Circuit, which both sides cite, but we think a careful reading of the case explains why *Cleveland* governs here and why it controls the outcome. So in that case, *Hedaithy*, the victim was a private company that sold the TOEFL test, administers the TOEFL test and submits reports. And the Third Circuit went through the various factors laid out in *Cleveland* and says this is a private entity pursuing a profit-seeking enterprise, it creates this information and sells it in the marketplace, its ability to do that is based on its trademarks, its assets, its business interests, and it has the ability to sell this authority to other entities. It has no regulatory authority. It has no sovereign power to

regulate. So on all the factors the Supreme Court listed in *Cleveland*, this is a private property interest, this confidential information.

If you run the same analysis in this case, which the government's brief doesn't even attempt to do, every factor shows that the PCAOB's regulatory information is a regulatory interest under the *Cleveland* case. It has sovereign authority to regulate in this industry.

The ethics code that governs the confidentiality of this information was enacted based on sovereign power that Congress conferred on the PCAOB to create the ethics code. It conducts these inspections not because it's competing in the market to get people to come and say let's look at your audits and bless you, is does that because Congress told them to do so and Congress requires that firms submit to inspections. And it can't sell this information for a profit, it can't sell its authority to conduct inspections, it can't sell its inspections. So on every factor that the Supreme Court said was relevant in *Cleveland*, this information fails to meet an intangible property interest.

The government relies on *Carpenter*, but *Carpenter* is a limited case, as the *Cleveland* opinion explains. *Cleveland* says in *Carpenter* we rely on these private property sources of authority, a corporate law treatise, prior Supreme Court opinions discussing confidential business information, to

conclude that a business' confidential information is something that's long been recognized as intangible property. But there is no similar authority for confidential regulatory information.

And I think this point is important: The government cannot point to a single opinion post-*Cleveland* upholding the use of the mail or wire fraud statutes to prosecute the disclosure of confidential regulatory information. It's never been used like this in a way that's been upheld post-*Cleveland*.

And the reasons, as we explained in our clear statements section, run into the same reasons that the Supreme Court did not want to expand the wire fraud statute in *Cleveland*. Governments have the ability to protect their confidential information, whether state and local governments, which the wire fraud statute applies to, or the federal government. The federal government has detailed structures about when disclosures of confidential regulatory information like classified information and cleared information will be prosecuted criminally. And in this case, the PCAOB's confidential information, Congress made the decision to attach serious civil and administrative penalties to a breach of that confidentiality rule.

And what the Supreme Court said in *Cleveland* is in light of all these other schemes -- in there they were particularly focused on the state and local clear statement

principle, but of course, as your Honor knows, the clear statement principles apply to federal regulatory schemes as well -- in light of these existing scheme, we're not going to expand the definition of property to cover intangible regulatory interests absent a clear statement from Congress.

In the nearly 20 years since *Cleveland* there has been no clear statement from Congress that they would like to revise the scope of the wire fraud, statute, and we don't think this Court should be the first to expand the wire fraud statute to cover this kind of information.

THE COURT: The government cites cases from the Fourth Circuit and the First Circuit involving stealing government information and things like that. I assume your argument on those is they're pre-*Cleveland*.

MR. SHAHABIAN: They're pre-*Cleveland* first and foremost, but that's not the only argument. They're both distinguishable even if they were post-*Cleveland*. So the *Fowler* case from the Fourth Circuit is not a wire fraud case, although it's cited for that in the government's brief. If you read the case, they're referring to Section 641, which is a separate statute which criminalizes any thing of value of the United States, and the Circuit is split on whether that covers confidential information, but it's not implicated in this case. So the *Fowler* case is simply inapposite.

Is the First Circuit case, the name escapes me, but

that case is distinguishable because the defendant never challenged the idea that confidential regulatory information can't be property. And we cited the defendant's brief in our reply brief where he concedes that it was. So it wasn't an issue the First Circuit ever had to consider to decide whether they actually reversed the conviction of defendant in that case, it's complete dicta, but as your Honor noted, they are also pre-*Cleveland*, so if there was any doubt, *Cleveland* clarified it.

THE COURT: You read *Carpenter* as limited to confidential business information, but I think there's this case -- there's a Second Circuit case, *Grossman* that actually points out that the word "business" isn't necessarily essential to the holding.

MR. SHAHABIAN: So *Grossman* is a case that says *Carpenter* is not limited to its facts. So in *Grossman* the defendant was a law firm, I think they had an associate who had stolen client information from the law firm. And he said well, a law firm, unlike the Wall Street Journal in *Carpenter*, doesn't publish this information, doesn't make money from disclosing confidential information, so this is different from *Carpenter*.

And the Second Circuit very quickly said that's ridiculous, this is still confidential business information -- and it used the term "confidential business information" -- of

the client who entrusted it to the law firm. It was a property interest. It didn't disappear when it went to the law firm. And in addition, the law firm had a business interest in protecting the confidentiality of this information. It needed to protect its reputation, people who trusted it to give it their information, they couldn't get clients.

And that's not the case with the PCAOB. It's not competing to get people to submit to their inspections, they're statutorily required to do so. So *Grossman* is simply saying *Carpenter* is not limited to exact facts, stealing a newspaper's confidential information, but it is still in the context of private confidential business information, not the regulatory kinds of interest.

THE COURT: Thank you. I think that answers all the questions I have. I appreciate that.

Ms. Greenwood, I don't know if you want to do your response to this first or if you a preference or do defendants have preference?

MS. GREENWOOD: I'm happy to defer to the Court.

MR. BOXER: We have no preference.

MS. GREENWOOD: I'm happy to save my response to the end.

THE COURT: Why don't we do that.

Are you next, Mr. Boxer?

MR. BOXER: I am.

THE COURT: All right.

MR. BOXER: A few points I would like to get across, your Honor. On behalf of Mr. Middendorf, we move to dismiss Counts Two, Three, Four and Five, wire fraud counts, for different reasons than just discussed with Mr. Shahabian.

First, we move pursuant to Rule 12(b). And that rule permits the Court to dismiss an indictment if it does not allege a crime. And what we got back from the government in opposition was opposition to our Rule 7 motion. We satisfied notice pleading, we said all the nouns of verbs in the wire fraud statute, it's premature for Rule 29 motion, it's not a time for summary judgment. These are almost all direct quotes. They did not, whatsoever, address the legal arguments and legal bases why we think those counts should be dismissed. And there's one reference where it says see Middendorf brief generally, but the essential argument we make is in a wire fraud, as part of proving a scheme to defraud, you need to prove a material misrepresentation or an omission in breach of a duty to disclose.

There are numerous Second Circuit cases about it. There are even Second Circuit cases that are entertaining motions to dismiss in cases where parts of indictments have been dismissed pretrial. We cite some of them. There are many of them. And it is absolutely not alleged against Mr. Middendorf in the indictment. There's no allegation that

he was aware of the breach of duty at the PCAOB, there's no allegation that he breached a duty to the PCAOB, and there's no allegation that Mr. Middendorf made a material misrepresentation to the PCAOB. It's just not there. And without it, they have not alleged the wire fraud. An interested comment at the end of Mr. Shahabian's argument is what the facts of this case look like is a 641 case, an embezzlement from the United States, because it charges embezzlement but it doesn't have the United States as a victim. And so it tries to fit a wire fraud into a 641 case.

And once it's a wire fraud, it's a wire fraud. And the government is required, in proving the scheme to defraud, that our client knowingly and intentionally and willfully either made a material misrepresentation or made an omission in breach of a duty. He didn't do that and he wasn't alleged to do that. He didn't do that, and they didn't allege that he was aware of anybody doing that. And that is a fatal deficiency in the substantive counts against Mr. Middendorf.

One argument that the government does make when it addressed this in one of the other briefs is that a crime of embezzlement is not complete until the use of the information. And they cite *Czubinski*, a case I think in the First Circuit, where the court essentially said that. The reason why that argument doesn't apply here is because embezzlement is a fraudulent appropriation to one own's use. That's black letter

law.

So it's true that the crime may not be complete as alleged until someone uses the stolen information, and it's true that they allege that Mr. Middendorf used stolen information, but the use is only relevant to the person who embezzles, who appropriates. There's no embezzlement when there's just use. Without the knowledge that there was an omission in breach of a duty or material misrepresentation and just the use, it's not embezzlement. And that's the situation precisely here.

I would just conclude by saying I appreciate the government said they pled nouns and verbs and all the appropriate words. They actually pled quite a bit, obviously, it's a lengthy and detailed indictment. But the detail they alleged does not allege a wire fraud against Mr. Middendorf. There's no allegation that he was aware of the breach of a duty by any PCAOB employees, past or present. There's no allegation that he breached a duty to PCAOB. There's no allegation that he made misrepresentations. And without that, they haven't alleged the wire fraud. And under Rule 12(b), when that happens, the Court should dismiss those counts.

THE COURT: Thank you.

MR. BOXER: Thank you, your Honor.

THE COURT: Thank you very much.

Mr. Bondi.

MR. BONDI: Yes, your Honor.

May it please the Court, your Honor, we join in the prior arguments and rise specifically to address Count Three of the indictment which appears in our docket entry as 58 and 83.

Your Honor, Count Three of the indictment alleges that Mr. Sweet, while in the employment of the PCAOB, took documents from a network drive on the PCAOB, downloaded those documents onto his PCAOB computer, and then took from those documents from his PCAOB computer, put them on a personal hard drive shortly before leaving his employment at the PCAOB, and walked out of the PCAOB.

Now the government in their opposition at page 27 concedes that this was illicit downloading of the information. Your Honor, for purposes of the government's theory of wire fraud -- which again we dispute and join in the prior arguments, but even if the government is right this is somehow wire fraud, the crime of wire fraud would have taken place at that point in time that Mr. Sweet took the information, put it on a personal hard drive, and walked out of the PCAOB forever.

Your Honor, at no point in the indictment, the 53 pages of the indictment, does the government allege that the defendants encouraged Mr. Sweet to take this information before he left his employment at the PCAOB, that they asked him do that, that there was some -- that they were part of some scheme to do that, or your Honor, there's not even any allegation that

they even knew that he was taking this information prior to leaving the PCAOB.

Your Honor, just because later in time he is alleged to have provided that information to others at KPMG does not mean that the wire fraud took place at that point in time. The wire fraud took place, according to the government's theory of wire fraud, at the point in time that he illicitly downloaded the information from the PCAOB, made it his own property, and walked out of the PCAOB.

As prior counsel mentioned, the government cites a First Circuit case, *Czubinski*, as support for the fact that somehow there have to be some use of reporting with this property. *Czubinski* involved an IRS employee while employed by the IRS accessed private information of other taxpayers, he was browsing information of other taxpayers improperly, and he was employed up until the point of his indictment at the IRS.

He doesn't download the information, he doesn't do anything with the information other than browse and look at the information. And the First Circuit said that's not enough, there has to be some sort of using the information.

What's interesting, the First Circuit points out, is one way, one example the court points out in dicta is that you can credit the information. That's effectively, your Honor, analogous to what Mr. Sweet did when he downloaded the information. And Mr. Sweet did that at a point in time right

before he left his employment at the PCAOB to then join KPMG. At that point in time, under the government theory, the wire fraud is complete, and there's no allegations whatsoever that the defendants were part of that scheme to deprive the PCAOB of that property. And your Honor, for that reason, Count Three of the indictment should be dismissed.

And I will yield to the Court for any questions.

THE COURT: The *Czubinski* case you mentioned, is that an embezzlement case or a fraud case?

MR. BONDI: The government charged wire fraud in *Czubinski*, if I recall correctly, your Honor, and the First Circuit overrule and said there had to be some sort of use of the information. In other words, he would have to have created some dossiers of the people he was looking at their tax returns for. Merely browsing the information didn't deprive the IRS of that property.

And one example that the government, or excuse me, that the First Circuit points out in *Czubinski* at page 1072 of the opinion is the Court says if he had printed the information, taken notes, created a dossier, at that point in time the crime of wire fraud would have taken place.

And your Honor, I submit that if the defendants had nothing to do with any of the information, and Mr. Sweet downloaded this information for his own personal use when he got to KPMG, the government would be charging Mr. Sweet with

wire fraud and pointing out the fact that he took the information and illicitly downloaded the information. It was the illicit downloading of the information that completed the crime of wire fraud, and whatever he did later is irrelevant as a matter of laws.

In terms of the use point that the government tries to make issue of, the fact of the matter is nowhere in the indictment do they say that the defendant used the information. While they allege that one of the defendants got the information -- and again, this is after the fact, after the alleged wire fraud would have already taken place as a matter of law, but they don't allege anywhere the defendants themselves used the information.

And it's very artful in their wording. At paragraphs 41 and 42 of the indictment, the government uses the phrase "engagement partners." They talk about Mr. Sweet providing the information to the engagement partners, and on page -- at paragraph 41 they say that gave engagement partners extra time to prepare for the inspection and audits. They're not even alleging in the indictment that the defendants used the information. So even under their theory about use, the defendants aren't alleged to have used the information.

THE COURT: Thank you.

MR. BONDI: Thank you, your Honor.

MR. SHAHABIAN: Your Honor, briefly, to clarify,

Mr. Bondi is correct, the *Czubinski* case was a wire fraud case, and the key language to emphasize this point that the First Circuit relied on was their intent to use. That hasn't been shown. There was in that case. Here, as Mr. Bondi stated, it was obvious, the government's theory is that Mr. Sweet took the information from the PCAOB. That was the intent to use.

THE COURT: Thank you.

Mr. Bloch.

MR. BLOCH: Your Honor, we rest on our brief as to Counts Four and Five of the indictment and join in the arguments of Mr. Shahabian and Mr. Boxer with respect to Counts One and Two applicable to Ms. Holder. She's not charged in Count Three, so I'm happy to be silent about that count.

THE COURT: That's fine. Thank you.

MR. COOK: Likewise, Mr. Wada submits on the papers and arguments made by counsel, but we would like the opportunity to perhaps respond to the government's arguments as necessary.

THE COURT: Very well.

MS. GREENWOOD: If I may have a moment, your Honor.

THE COURT: Sure.

(Pause)

THE COURT: Ms. Greenwood.

MS. GREENWOOD: Your Honor, unless you have specific questions to start for me, I would like to spend a few moments

on the indictment before responding to each of the defendant's arguments.

THE COURT: Okay.

MS. GREENWOOD: The indictment in this case, which is what we're here today about, charges the defendants with participating in a large-scale, years-long scheme to defraud the SEC using confidential information that was stolen from the PCAOB and disseminated by its current and former employees in breach of their duties of confidentiality and loyalty.

Specifically, the indictment details how the defendants, each of whom were high level executives at KPMG or long-time employees of the PCAOB engaged in inspection work, sought out or disclosed information about which KPMG audits would be inspected PCAOB. This happened in 2015, again in 2016, and again in 2017. As the indictment makes clear, this inspection information was kept highly confidential at the PCAOB so that it would not influence the outcome of PCAOB inspections.

We know exactly why the defendants embarked on this scheme, because as the indictment alleges KPMG was facing a crisis. By at least 2014 it was performing twice as poorly in PCAOB inspections as its competitor firms. And its performance was not only bad for business, it put KPMG directly in the hot seat with the SEC.

So in 2016, as the indictment alleges, as the SEC held

top executives of KPMG, including its CEO, the vice chair of audits, and the defendant David Middendorf to a meeting with SEC chief account who told KPMG about the concerns that the SEC had about audit quality issues at KPMG based on its poor performance in PCAOB inspections.

KPMG acknowledged those concerns, including issues with a particular financial metric used in auditing financial institutions known as ALLL. This was a bet-the-company moment for KPMG. And I can't understate the measures that KPMG underwent in order to address these concerns by the SEC, and also their poor performance of PCAOB inspections, as alleged in the indictment.

They began recruiting former PCAOB employees, including cooperating witness Brian Sweet and the defendant Cynthia Holder. They hired a data analytics firm to help them predict what audits would be inspected by the PCAOB. They initiated bonuses for clean inspections with the PCAOB.

THE COURT: By the way, the hiring of the data analytics firm, there's nothing illegal or unethical about that, is there?

MS. GREENWOOD: That's correct, your Honor. These were measures that KPMG attempted to take in a legitimate effort to determine which KPMG audits were going to be inspected, and in order to attempt to, like you say, in a legitimate way anticipate which audits would be inspected by

the PCAOB so they could pay extra attention to those particular audits and ensure there was increased audit quality. The government takes no issue with those steps, but as the indictment alleges, the defendants and their co-conspirators went even further to ensure that their results on the test would be even better than they could do themselves.

So as alleged in the indictment, they pressured Brian Sweet to obtain and disclose confidential PCAOB information that would allow them to cheat on the test. And for example, defendant Holder, through Brian Sweet, was asked to provide confidential information from the PCAOB, which he in fact provided. Defendant Wada likewise provided confidential PCAOB information that he described as a grocery list.

And as the indictment alleges, the plan worked. KPMG was able to used the stolen PCAOB information to do additional audit work that it otherwise would not have performed, and identified significant issues on audits that it otherwise would not have identified because additional audit work was not allowed to be done at the time that they received the confidential information and performed that audit work.

THE COURT: So it went back and did better audits on the issuers with the heads up about who they, as auditor, were going to be audited.

MS. GREENWOOD: That's correct, your Honor. There's specific allegations that with respect to -- it's specifically

audits that were identified as being on the PCAOB's inspection list, the people who were going to be subject to a pop quiz, that after the time that the --

Sorry, your Honor.

THE COURT: No, finish your thought.

MS. GREENWOOD: After the time that the accounting standards would have allowed audit work to be performed, they went back into archived audit files and identified audit issues.

THE COURT: Here's what I was going to ask: The indictment alleges that that there's two oversight roles of SEC. One is to look at how the auditors are doing as auditors of the auditors, and the other is to look at issuers and find problems. So as to the issuers it actually helped. They got better information as a result of the fraud, right?

MS. GREENWOOD: Certainly, your Honor, with respect to certain issuers I think it can be said that issues were identified that would not have otherwise been. So with respect to financials of those particular issuers, it may well be that the audit turned out better.

I think the SEC's response at trial, when we talked to them about the impact of this, is the fact that one audit was improved for one issuer is really not the goal, it's to ensure that the auditing program at KPMG, and other auditors like KPMG, actually have integrity and actually have quality and can

assure that future inspections and future audits of public companies are in fact properly done. The fact that you receive advanced notice and improve one inspection result does not improve the health of financial industry. I think that that certainly is going to be plain at trial, and I think it's alleged in the indictment as well.

Your Honor, again, not to belabor the point, but as the indictment makes clear, the impact of this fraud, as we were just discussing, was that the PCAOB, which had a statutory duty not only as Mr. Shahabian referenced to report or to issue inspection reports to the SEC, but to issue reports pursuant to 15 USC 7214(c)(2) that identify acts or practices that may be in violation of it SOX, SEC rules for PCAOB rules, and report any such act, practice or omission as appropriate to the SEC.

In conducting the fraud the way that they did, the defendants prevented the PCAOB from being able to identify issues like the fact that they went in and did audit work outside of the time period that the accounting standards would allow, and that tainted the integrity of the PCAOB inspection results and the process.

And make no mistake, your Honor, the indictment alleges in paragraph after paragraph that the defendants knew what they were doing was wrong, and that the information that they were using was information obtained from the PCAOB improperly. The indictment alleges that the defendants were

told this was information that PCAOB had not disclosed, that it was information that had been obtained from current employees of the PCAOB, they created cover stores and lied about why they were using information, and talked about using burner phones to destroy documents. The allegations are very clear with respect to intent. So that's why we're here.

Again, before I go quickly through legal arguments, the defendants engaged in a very clear scheme that falls both within Section 371 as a scheme to defraud the SEC, and aided and abetted and conspired in a scheme to steal and use confidential information from the PCAOB.

I'll start, your Honor, with the arguments made with respect to joint brief, if I may.

With respect to first point the defendants focus on in their joint brief with respect to whether or not the indictment alleges a scheme to targeted at the SEC, I think the indictment does just that, your Honor. As you noted during the defendants' argument, it's not that the scheme has to be a scheme solely with the goal of defrauding the SEC. As alleged here, it has to be a scheme that at least one purpose of which was to defraud the SEC.

THE COURT: But what about the argument that it was knowledge, it was knowledge versus purpose? They knew this information would go to the SEC, among a bunch of state regulators and others, but the purpose isn't alleged to be

defrauding the SEC as opposed to the PCAOB.

MS. GREENWOOD: To be clear, your Honor, that argument is based solely on reliance on the to wit clause. And I think the defendants' reliance on that clause is seriously overstated.

As an initial matter, a 371 case doesn't even have to include a to wit clause, and the word "knowingly" wouldn't even need to appear in any to wit clause in order to sufficiently state a 371 claim.

The to wit clause here is merely a description and summary of the means used. It's not a fulsome description of the mens rea used or alleged by the government in order to satisfy Section 371.

In fact, if you look in context, in paragraphs 90 to 92 of the indictment, we do allege willful and knowing participation in a conspiracy. And then an object of that conspiracy was willfully and knowingly defrauding the SEC. That's our mens rea allegation, your Honor, and frankly, that stands in and of itself with respect to intent.

But the factual allegations of the indictment make very clear that not only was defrauding the SEC at least a secondary motive of this scheme, but quite frankly the SEC's pressure and criticism of KPMG appears to have motivated much of what happened.

And I will point you to a few specific paragraphs in

the indictment. Paragraph 59 sets out, as I mentioned earlier, the pressures that KPMG was facing by 2014 with respect to the poor performance and inspections by the PCAOB, paragraphs 59 and 16, excuse me, your Honor.

17 and 18 detail the impact that their poor performance inspections were having on KPMG's bottom line, and the multilevel approach that they adopted to attempt to improve PCAOB inspection results.

Paragraph 60, your Honor, describes the February 2016 meeting where the SEC brought in KPMG's CEO and defendant Middendorf to discuss audit quality issues based on poor performance in PCAOB inspections, and in particular, ALLL issues.

And paragraph 61 discusses additional meetings held after that time all to discuss ALLL issues with defendant Britt as well as others at KPMG.

And paragraph 67, your Honor, brings the entire narrative to -- sort of closes the circle on the ALLL narrative. When the SEC brings in KPMG to talk about PCAOB inspections, they flag ALLL as the cornerstone issue. And specifically when the defendants use the stolen PCAOB information about inspections, they use it in connection with ALLL and they go back and conduct a stealth rereview, described in paragraph 67, purportedly of all engagements in the ALLL monitoring program, but really only looking at issues with

respect to engagements that were on the PCAOB inspection selection list. So they specifically used this information to address concerns that the SEC had raised directly with KPMG.

Based on that, your Honor, the statutory language, the factual investigations all make clear that one of the motives of the scheme at issue was to defraud the SEC with respect to its oversight of the accounting industry, the financials, and its review of PCAOB inspection rules.

And I would point, your Honor, to *United States v. Gurary* as sort of our counterpoint to the *United States v. Tanner* case. And to be clear, your Honor, the *Tanner* case simply stands for the proposition that federal oversight of a non-government agency by itself does not transform that government agency into -- or sorry, does not transform that non-governmental agency into the United States for purposes of a Section 371 case.

It does not address the situation like the one here in which the oversight system itself involves communications that flow up from the non-governmental agency directly to the United States. In fact, *Tanner* recognizes that where the fraud flows up the chain from the non-governmental entity to the government entity, that can be the basis of a 371 claim. And that's precisely what is alleged here, your Honor.

So *Gurary* is an example -- defendants in that case, although it was not their primary purpose, had as part and

parcel of their scheme to defraud the IRS because they knew that fictitious invoices that they created and provided to non-governmental third parties would he reported on their books and records on which their corporate tax returns would be based. In order for the defendants' scheme in *Gurary* to succeed, the IRS had to be defrauded, and that was sufficient because it was part and parcel of the scheme they were conducting here.

And same is true here, your Honor. In order for the defendants' illicit use of PCAOB inspection results to be effective, in order to reduce the concerns and scrutiny they were receiving, it had to also defraud the SEC. Because otherwise, if the SEC were not convinced, they would continue to be subject to the same type of scrutiny that they had been as alleged in the indictment.

THE COURT: Do you want to address sort of at a high level the arguable inconsistency between -- or why there's not an inconsistency between Count One and the wire fraud counts? In particular, what you have been arguing is how this was all tied with the SEC, given the information was inevitably going to the SEC, but isn't it true that your wire fraud counts rely on this being essentially information that is not intangible regulatory type information?

MS. GREENWOOD: Sure. I don't think that the theories are inconsistent, your Honor. Under Section 371 we have

treated the PCAOB as a matter of the statute and recognized in *Free Enterprise* as a non-governmental entity. And for statutory purposes, as the Supreme Court recognized and as the parties conceded in *Free Enterprise*, although the PCAOB performs some regulatory function, or primarily a regulatory function, it is a private non-governmental entity. So for that reason, of course we did not charge that the fraud was -- that the Section 371 fraud was directly on the PCAOB.

However, I don't think it's at all inconsistent to say that even a non-government entity that performs a regulatory function can still possess information that is confidential information that is protected by the wire fraud statute. Those two things are not inconsistent.

And if I may, I can pivot to the wire fraud count, if that's helpful, although I do want for a moment to talk about the fraud on the SEC element.

THE COURT: But the reason it's confidential -- turning to the wire fraud, the whole reason it's confidential is for a regulatory purpose, not for some business purpose or because it's competing. You might have PCAOB information that is confidential for business reasons, like it's trying to lease a building somewhere and it's looking at different prices from different landlords or something, and that might be confidential for purely business proprietary reasons. But this is information that is confidential solely to promote a

governmental regulatory purpose.

MS. GREENWOOD: I think, your Honor, when you look at *Cleveland* and the regulatory interests there, the question is not so much the purpose of the information, but looking at the nature of it in terms of it being held by the PCAOB, and ultimately whether we're talking about information or an interest.

So the government has not alleged, for example, that the PCAOB's right to decide what inspections it wants to inspect without interference was the right that was interfered with. We have alleged information, which is an asset at the heart of the PCAOB's work, was stolen.

And significantly, your Honor, this is not an issue like in *Cleveland* where the only cost to PCAOB, like the licensing authority in *Cleveland*, was the cost of a stamp and the paper it took to print a license. This was information that the PCAOB invested time and resources into in order to create, although for regulatory purpose, so it could use that information in order to carry out that purpose.

And your Honor, I think, again, I want to point you to the specific paragraph in the indictment, if you look at paragraph 6, it talks about PCAOB inspection selections are based on information that the PCAOB collects from audit firms, and undergoes months of analysis of a variety of factors, including issues with respect to how long it's been since an

audit has been inspected, looking at risk factors for particular audit firms.

And your Honor, we don't quantity the amounts involved in the indictment. I can tell that you the government anticipates that the evidence at trial will include testimony from the PCAOB that just with respect to 2017, as an example, it costs the PCAOB in excess success of $500,000 in resources to generate its inspection list. Over half a million dollars.

This is not a case, as I said, like in *Cleveland*, where the only interest infringed upon was Louisiana's ability to issue a license and to print that license on a piece of paper and send it to a recipient. And also in *Cleveland* the court spends time discussing the fact that although the licensing authority in *Cleveland* was defrauded of its ability to decide based on complete and honest information whether or not to issue a license, it had already received the revenue that it was expecting in order to make that decision. The fee in order to make the licensing application had been paid. They were out no money.

By contrast, the PCAOB not only expended those upfront costs I mentioned alleged in the indictment, but at trial we would show that in 2017, in order to recreate its inspection lists, and in light of the defendant's fraud, expended in excess of $200,000 over and above in excess of the $500,000 it expended in order to generate the lists in the first place.

So I think we are a far cry from a mere regulatory interest here. We're talking about an asset, information that the PCAOB dedicates its precious resources to developing, that it dedicates staff members' time, hours, to create this inspection selection, granted in furtherance of its statutory regulatory role, but we're not in the realm of *Cleveland* where this is a mere regulatory decision.

I would also note, your Honor, Mr. Shahabian when he argued, he pointed out there's not been a single case in which the type of quasi regulatory information here has been deemed protectable under the wire fraud statute. I would say the opposite is also true. This is sort of a novel entity, but there are no cases in which a nonprofit has been deprived of its property rights merely or because it was a regulatory or quasi regulatory entity.

We're not dealing here with a government agency, we're dealing here with a nonprofit corporation. And specifically, your Honor, when Congress made the decision to provide certain regulatory powers to the PCAOB, but to nevertheless designate it a non-governmental agency, part of the implication of that was that statutes like the wire fraud statute that apply to nonprofit corporations, of which the PCAOB is, would apply to the PCAOB.

So I think the fact that there may be alternative remedies for this type of theft, for example under SOX, is

certainly no bar and is totally consistent with the fact that there are also separate remedies when and if an entity like the PCAOB is stolen from and its confidential information is taken.

If I may, your Honor, I think just to pivot back briefly to Count One, in addition to alleging a scheme targeted at the SEC, the indictment does more than enough to allege the fraud was on the SEC. The defendants acknowledge that by alleging an agreement to transmit a false statement to the SEC or violate a duty to the SEC, either directly or through an intermediary, that the indictment would allege an offense under Section 317, provided that the fraudulent act reached the government, either directly or indirectly, and there was a false statement or violation of duty to the government.

THE COURT: Where do you propose that from?

MS. GREENWOOD: That's from the joint reply brief at page 5, your Honor.

THE COURT: Okay.

MS. GREENWOOD: This is not a case where we have to deal with sort of the edges of what is allowed and what isn't allowed under Section 371, because at a minimum, as alleged in indictment, we have a situation in which the PCAOB provided false and misleading information to the SEC in violation of its statutory duty.

As I noted, your Honor, the PCAOB has a duty not only to provide inspection reports to the SEC, but to report

violations of SOX and SEC rules and accounting standards that it identifies as part of its inspections.

Paragraph one of the indictment discusses the SEC's role in implementing the enforcement of securities laws under SOX.

And paragraph four, as I mentioned, talks about PCAOB inspections, ensuring compliance with those rules and the accounting standards. One of those, as I alluded to earlier, your Honor, is the 45-day rule, which is that after the 45 days following the close of an audit, the documentation is supposed to be archived and not supposed to be accessed again, alleged in paragraph three.

And alleged in paragraph eight, the PCAOB as a general matter keeps its inspections selections confidential and doesn't tell auditors about them until the close of the 45-day period precisely to keep situations like the one in this case from happening in which auditors game the system by knowing which audits are subject to inspection before the PCAOB comes around to inspect.

Paragraphs five and eleven detail the PCAOB's requirement to report its inspection findings to the SEC.

And paragraph eleven, your Honor, alleges in sufficient detail that the SEC uses those inspection reports -- and this is key, your Honor -- to carry out its regulatory oversight and enforcement functions, including to monitor audit

quality, to identify weaknesses in issuer financial statements that it refers to the division of enforcement and corporate finance. That's the alleged fraud. That is the function of the SEC that was obstructed in this case. I don't see how much more specific the government would have needed to be, but paragraph eleven squarely alleges the legal function of the SEC that was obstructed in this case.

If you look at 72, paragraph 72 of the indictment, your Honor, goes through the issue I discussed with respect to the defendants using this PCAOB inspection information after the time that the audit would have been allowed under that 45-day documentation rule to perform new audit work and identify new issues without disclosing the conduct of that audit work to the PCAOB in its work papers.

So taken together, your Honor, I think the indictment's not only the statutory allegations but the factual allegations are more than sufficient to allege the 371 violation.

THE COURT: Maybe you're getting to this, but I want you to respond to Mr. Boxer's point about the allegations not being sufficient with respect to that his client was aware of a duty to -- breach of a duty at all.

MS. GREENWOOD: Certainly, your Honor. I would, again, turn us back to the indictment allegations to be very express about what is alleged.

So following the -- and we're talking about, your Honor, about the wire fraud counts, Counts Two through Five?

THE COURT: Yes.

MS. GREENWOOD: So I think, your Honor, the indictment does in fact allege that with respect to -- and to be clear, Counts Two through Five charge wire fraud in the context of a scheme, a conspiracy, and also in the wire fraud counts, the defendants are charged with aiding and abetting violations.

So I believe there was mention I believe in Mr. Middendorf's argument that he himself did not breach a duty. That's now how this case has been alleged. The duty that has been alleged is the breach of duties of confidentiality and loyalty by former and current PCAOB employees who are disclosing information they're not permitted to disclose.

And the indictment, in discussing the provision of stolen PCAOB information to the defendants, repeatedly alleges that they -- alleges facts to suggest they understood the information either non-public or had come from the PCAOB.

Here's some examples from the indictment, your Honor:

With respect to defendant Middendorf, in paragraph 33 and 32, it discusses a lunch that he attended, or Middendorf asked Sweet following his start at KPMG and after he left the PCAOB whether a particular issuer would be targeted by PCAOB inspections and were generally what KPMG engagements would be

inspected.

In paragraph 33 he tells Sweet to remember where his paycheck came from and to be loyal to be KPMG.

Paragraph 66 and 67 discuss a conference call in March 2016 where defendants Middendorf, Whittle and Britt agree to conduct stealth rereviews using the stolen PCAOB information, and Middendorf and Whittle on that call discuss the need to keep the 2016 list of inspections secret, and the nature and extent of the rereview secret.

Paragraph 83 details a conversation in which Brian Sweet told Middendorf, Britt and Whittle about the 2017 final list, and Middendorf said it was simply too good to pass up.

With respect to defendant Whittle, your Honor, paragraph 34 discusses a May 2015 lunch between Sweet and others. And in the course of that meeting, Whittle asks Sweet for the list of engagements to be inspected by the PCAOB and Whittle tells Sweet that he's most valuable to KPMG at that moment and will soon become less valuable.

The following day, May 8, 2015, Sweet emails Whittle a list of inspection selection saying just so you know, it's actually the full list of anticipated inspections, including non-bank. I appreciate the team's discretion in the nature of not disseminating, to which Whittle responded: Got it, and understand the sensitivity. That same day Whittle forwarded the list to Middendorf and said the complete list, obviously

very sensitive, we won't be broadcasting this.

Some examples with respect to defendant Britt, paragraph 39, Britt emails Sweet asking for the 2015 list, and Sweet responds saying: Please note there's some sensitivity with these and some of the teams have not been officially notified by the PCAOB, so please use your discretion with this information.

Paragraph 68, March 2016, Britt has a conversation with at least two individuals at KPMG about the use of 2016 list in which he expresses the need for secrecy, telling a partner that he couldn't tell him the source of the knowledge and telling another partner to keep his mouth shut.

Paragraph 69, March 2016, Britt sends an email to engagement partners with a false reason for needing to access audit files. That was based on access to PCAOB information.

These are just some examples with respect to these three defendants. And I think, given not only their position within KPMG, executives within the department of professional practice and audit group, the particular interactions they had with the SEC, their understanding about the timing of PCAOB disclosures and inspection selections, and on facts as alleged here, as well as others, I made very clear that they understood that the information they were receiving they were not supposed to have, and they weren't supposed to have it because it was obtained in breach of a duty.

Turning more broadly, your Honor, to the arguments with respect to Count Three, I believe defendants Middendorf, Whittle and Britt again join in the argument that their obtaining and use of information that Sweet had embezzled while an employee of PCAOB cannot form the basis of the 2015 wire fraud count which alleged in Count Three.

I think the argument by the defense ultimately goes too far. The cases that they discuss with respect to completion of an active embezzlement are primarily -- and the cases I have been able to find, your Honor, are in the context of when does the statutes of limitations for a particular embezzlement stop to run.

So the cases say it's not a continuing offense, and that, for example, once you have obtained the information the statute of limitations begins to run and that crime is complete. However, the cases say nothing about whether you can charge multiple acts of embezzlement and multiple acts of using confidential information in violation of duties based on serial disseminations and serial disclosures of that information.

So for example, your Honor, when the indictment alleges that in 2015 Britt -- excuse me, Sweet begins working at KPMG and the defendants Britt, Whittle and Middendorf encourage him and in facts obtain confidential PCAOB information from him, the cases say nothing about whether we can charge that act separately. So it's the government's

position that the wire fraud alleged with respect to that conduct in 2015 standing alone is its own crime that could be alleged separately from whether or not there was a separate embezzlement or separate wire fraud that happened when Sweet left the PCAOB.

And further, your Honor, I would note that with respect to the 2015 allegations, the government does allege that certain information was provided by Sweet orally, not based solely on documents, and certainly that use of the confidential information would not have -- did not happen until the defendants encouraged Sweet to provide that information.

And also there's information alleged in the 2015 time period that was obtained after the encouragement by Britt, Whittle and Middendorf when Sweet then went back to defendant Holder and obtained additional confidential PCAOB information while she was still at the PCAOB.

All of those allegations are part of the Count Three, your Honor, and all of which were presented to the grand jury in this case. And again, I think that the defendant's argument with respect to completion of the embezzlement is sort of neither here nor there with respect to whether or not the government has sufficiently alleged this wire fraud in Count Three.

THE COURT: What's your response to the argument about there was no actual statement or omission where there was a

duty?

MS. GREENWOOD: Again, your Honor, I think with respect to obtaining -- with respect to Counts Two through Five, your Honor, the crime is obtaining the information in violation of a duty. So the embezzlement -- for example, obtaining information in violation of a duty is embezzlement, and that can satisfy the obtaining property prong of the wire fraud statute.

And again, here, as alleged in the indictment, the defendants, from whom confidential information was obtained, including or in addition to cooperating witness Brian Sweet, owed duties of confidentiality and loyalty to the PCAOB, including a lifetime ban on disclosure of confidential information as former employees of the PCAOB. So that's the theory that the government is alleging with respect to the embezzlement aspect, misappropriation aspect of Counts Two through Five.

I want to look through my notes briefly on the other arguments to make sure I hit everything.

(Pause)

MS. GREENWOOD: Unless the Court has specific questions, the government would rest otherwise on its papers and again emphasize that this is a case that I don't think we are dealing with anywhere near the borderline of the edges of 371, 1343. This is a pretty straightforward scheme. It does

involve an entity that is somewhat novel, but the defendants, as alleged, conspired to steal information and use it for an improper purpose. And those allegations are more than sufficient to state the offenses in the indictment.

THE COURT: Thank you, Ms. Greenwood.

Does anyone want to reply briefly?

MR. SHAHABIAN: Yes, your Honor, a few points to make.

So actually I would like to start with something that is not in our briefing because I did not know that the government was making that argument until they said it right now.

So if I understand Ms. Greenwood's arguments correctly, they're now arguing that for the 371 count, that is a fraud on the United States, that the PCAOB had a duty in its inspection reports to include violations of various regulations and transmit those to the SEC, and that those were not transmitted. And for that duty, Ms. Greenwood cited to 15 USC 7214(c).

That is not a duty that 7214(c) creates. What 7124(c) says -- and it's a different provision than the provision about transmitting inspection reports, which is at 7214(g). What 7241(c)(2) says is the board, quote, if appropriate, should report violations of various accounting rules to the commission. Other provisions of Subsection C say the board, if appropriate, should engage in its own enforcement actions.

And to add a few more citations that are not in the briefing, the implementation of that statute shows there was no duty to include information to is the SEC. It's solely within the PCAOB's discretion. So that statute is implemented in PCAOB Rule 4004. And the notice of proposed rule making for Rule 4004 is at 69 Federal Register 22103, page 22106. And at that page, the PCAOB says, in going back to the statute, to report any violation, quote, if appropriate, to the commission.

The PCAOB said the phrase: If it determines appropriate in Rule 4004, which implements that statute, is meant to signal that the board will decide which of these acts, practices and omissions would be appropriate to refer to the commission and to the states or other authorities. In making this determination, depending on the nature of possible violation, the board could conclude that it be appropriate to report information to the commission and not the states or other authorities, and vice versa.

So in other words, this statute doesn't the create any duty on the board to include violations in the inspection reports themselves. To the contrary, this gets back to where we started. What did Congress do when it created the PCAOB? It created a regulatory entity with the power to enforce violations of its own provisions through civil and administrative remedies.

If appropriate, it was, of course, free to refer those

violations to the SEC, but it had no duty to do so. And so any failure to include information in the inspection reports can't be the legal hook for a duty that was violated that creates a conspiracy to defraud the United States.

And the Second Circuit made that clear in the *Coplan* case. And in that case Ernst & Young partners were accused of creating an illegal tax shelter scheme and hiding marketing materials, instructing their employees to take these marking materials back from clients so the IRS doesn't see them. The Second Circuit vacated the conviction holding there was no duty to turn over those documents, and absent a duty, that can't be the hook for conspiracy to defraud the IRS. The same is true here.

And another point on the 7214 argument, and the reason we didn't address it in our briefing it's not in the indictment. And again, *Pirro* explains that a motion to dismiss must be adjudicated on what is alleged to be in the indictment, not how the government wishes they would have written the indictment. And there is, on the face of the indictment, no allegation of a breach of a duty to the SEC, or the submission of a false statement in an inspection report to the SEC.

The only language in the indictment is in paragraph 91 that says fraudulently affect inspection outcomes. The Second Circuit made clear you can't just add the word "fraud" to something and have that sufficient to explain what the fraud

is. It must be a false statement. It must be the violation of a duty to disclose. And absent that allegation, the indictment doesn't charge a fraud on the SEC.

Staying with the 371 count and turning back to the purpose point, Ms. Greenwood ran through various allegations in the indictment, and as your Honor pointed out, some of them allege things that are perfectly appropriate, such as hiring a data analytics firm. She referenced meetings with the SEC to talk about allowances for loan and lease losses, that's the ALLL issue.

The indictment never alleges that the scheme to misappropriate confidential PCAOB information and affect the outcomes was intended to interfere with any of those functions. To the contrary, at other points in the indictment, paragraph 18, KPMG set up a monitoring program to resolve its issues relating to ALLL. There's no tie at all between these various functions that are listed in the indictment and the scheme, an agreement to defraud a specific lawful function of the SEC.

The agreement -- and we're not playing a magic words game. Ms. Greenwood suggested the to wit clause is not necessary. They didn't allege it throughout the indictment. We're not saying it had to appear in a specific place. But the only place that alleges it is paragraph 91. That's where they try to define the agreement, and it simply states misappropriate confidential information knowing it would affect

regulatory and enforcement functions of the SEC, without ever defining what those functions are.

And as we jump between things, as your Honor noted that are perfectly appropriate, such as hiring an analytics firm, creating a monitoring program to improve audit quality issues, SEC functions that were not at all impeded by the alleged scheme like the improvement in issuer quality, it's impossible for the defendants looking at this indictment to understand what the crime is, what the line crossed into for criminal conduct that defrauded a specific lawful function of the SEC. And that's why under *Pirro* the remedy has to be dismissal.

Turning to the wire fraud counts, *Free Enterprise* makes clear that the PCAOB is not, as the government suggests, merely a private non-governmental entity. To the contrary, what the Supreme Court said in *Free Enterprise* is that the PCAOB is, quote, the regulatory of the first resort and the primary law enforcement authority for the accounting industry. It, quote, wields the executive power of the United States.

The board members, as your Honor noted, are inferior officers to the United States. Congress made specific decisions when it created the PCAOB, took it out of the formal United States government, but it gave it a regulatory function. And under *Cleveland*, that is the key here.

So then we turn to: What is the interest that is

alleged to be defrauded? *McNally*, *Skilling*, *Cleveland* all make clear there has to be property interest.

In this case, it's not, as Ms. Greenwood suggested, simply information. The alleged right that has been interfered with is an intangible right to control the dissemination of information, that is, to protect the confidentiality of the information. And *Carpenter* makes clear that that is the kind of intangible right we're talking about. It held that the Wall Street Journal's information was private property because it said -- and this is at page 26 of the opinion -- quote, the confidential information was generated from the business, the business had a right how to decide how to use it prior to disclosing it to the public. The Court went on to note that, going into page 27, exclusivity is an important aspect of confidential information, and most private property, for that matter.

So what *Cleveland* does is it take that language of intangible right, the right to exclude, the right to control. And what it says is it may be private property when a private entity does it for business purpose, when a patent holder licenses a patent, when a newspaper publishes news, when a franchiser franchises his business. But when the government does it, when the government decides how it's going to control its intangible right, its right to exclude others from knowing its confidential information, that ceases to be a private

property right, it's an intangible right, a regulatory right that is not the subject of a wire fraud prosecution.

Instead, the government turns to the resources expended by the PCAOB to make the list. If that argument were accepted, that the resources expended by the government turn an intangible right into a private property interest, then *Cleveland* is meaningless, because the government, of course, expends resources for everything it does.

The licensing scheme at issue in *Cleveland* required the expenditure of resources. The agents of the state had to process licenses, give out applications, do background checks. The fact that resources are expended by the government doesn't mean everything it does suddenly becomes a private property interest under the wire fraud statute. If that were the case, *Cleveland*, *McNally*, all of the cases where the court made clear the narrow scope of the wire fraud statute, would be meaningless.

And similarly, the allegation that it cost resources to redo the list after the scheme was discovered, there's no allegation that the intent of the scheme to deprive the confidentiality of the information is intended to force the victim to spend money to recreate the information when the embezzlement is discovered, and it is certainly not the theory that appears in the indictment.

The government also stated in their rebuttal that they

have sufficiently alleged that there is false and misleading information in the inspection reports. Respectfully, your Honor, we reviewed the indictment, it does not state that. The only thing it states in paragraph 91 is that the information was used to, quote, privately affect PCAOB inspection outcomes. It adds the conclusory label "fraud" onto what happened, but it never explains what was the fraudulent conduct. Was there a false statement in those inspection reports? It never quotes from the inspection reports. Was there a violation of a duty? It doesn't say that.

So again, we're back to where we started, which is Congress made choices about how PCAOB would be structured, how violations of its rules would be enforced. A violation of the confidentiality rule, according to Sarbanes-Oxley, is a civil and administrative matter. To get around that choice, the indictment has decided to take the generic conspiracy statute and the generic wire fraud statute and apply them in a way that has never been done before.

This would be the first case to allow a conspiracy to defraud prosecution to go forward where the fraud on the United States is never defined. It would be the first case to allow a wire fraud prosecution to go forward post-*Cleveland* based on intangible regulatory information. It's never been used in any sort of government lead prosecution and upheld post-*Cleveland*.

And we would submit, respectfully, that under basic

principles of due process, statutory interpretation and what is required to be charged in an indictment, this indictment does not state an offense and must be dismissed.

THE COURT: Thank you.

Does anyone else want to reply to something?

MR. BOXER: We do not. We will rest on our argument and our brief.

THE COURT: Thank you.

MR. BONDI: We'll rest, your Honor.

THE COURT: All right. Very well.

Did you need to respond to anything?

MS. GREENWOOD: Just very, very briefly, your Honor.

THE COURT: Sure.

MS. GREENWOOD: To be clear, the scheme at issue here, your Honor, caused the PCAOB to not be able to speak truthfully to the SEC when it was reporting to the SEC there was a PCAOB inspection. It caused deception, it caused a misstatement. And that is the heart of our Section 731 claim, your Honor.

With respect to just one last point, your Honor, that Mr. Shahabian made with respect to *Cleveland*, this is not a situation where we said because there is some expenditure in some licensing regime that the licensing regime somehow becomes property. Here it's very clearly tied to the creation of the information, and specifically the PCAOB's expenditure of resources to compile and create information that is the very

heart of the business and the work it performs. Stealing that information is a crime, your Honor.

Nothing further.

THE COURT: Thank you.

Thank you very much. I appreciate the very able lawyering by all the parties in the case, both in the briefing and the argument today.

I will mention a couple of other things. Decision is reserved as to these motions. There are a few other motions, I understand. There's a motion for release of Brady materials which was filed on May 24, there's a motion for a bill of particulars filed on May 25, and then there's a motion to unseal that I received by email with respect to the Brian Sweet case, and I believe I'll be getting responses -- I don't think I have responses to those by the government, but you are planning to respond to those?

MS. GREENWOOD: That's correct, your Honor.

THE COURT: Do you have dates for the responses?

MS. GREENWOOD: Your Honor, we expect at a minimum to reply to the unsealing motion tomorrow, and we would ask to be allowed to put in a letter asking for the time that we need to respond to other two tomorrow as well.

THE COURT: That's fine. As you know, defendants' motions to compel discovery any other motions related to compelling discovery are extended to June 8.

All right. Thank you all very much. We're adjourned.

(Adjourned)